LLOYD C. BLANKFEIN HENRY M. PAULSON, JR. JOHN A. THAIN

On January 14, 2004, John Thain retired as President and Chief Operating Officer of Goldman Sachs to become Chief Executive Officer of the New York Stock Exchange. John was succeeded by Lloyd C. Blankfein.

We are very proud that John was selected for this role, following in the tradition of service established by many generations of Goldman Sachs leaders.

John had a long and successful career at Goldman Sachs, distinguished by his character, rigorous intellect and devotion to the firm's culture. He helped Goldman Sachs transition from a private partnership to a public corporation, encouraged new business development, and spearheaded many initiatives to strengthen the firm's culture and develop our people.

All of us at Goldman Sachs are profoundly grateful to John for his many lasting accomplishments at the firm.

Fellow Shareholders:

Looking back on 2003, we take pride in our performance during a very challenging year. Net earnings in 2003 were $3.01 billion, a 42% increase from 2002. Earnings per diluted share (EPS) were $5.87, a 46% increase from 2002, and our second highest reported EPS as a public company. Our 2003 return on average shareholders' equity was 15%, up from 11% in 2002. Our return on average tangible shareholders' equity was 20%, well above the 15% earned in 2002.

By its nature, our business doesn't lend itself to predictable recurring earnings. As we often remind our people, Goldman Sachs cannot control the market environment in which we work. But we can control our relative performance. By this standard, we judge 2003 to be a success and further evidence of the strength and resilience of our franchise.

Despite our success in 2003, most of us will remember the past year as one in which we faced the continuing fallout from the collapse of the high-tech bubble and the series of corporate scandals that followed. It was an environment marked by sharp criticism and intense scrutiny of corporations generally, and financial services firms in particular.

At Goldman Sachs, we continue to experience enhanced regulatory scrutiny in all areas of our business. While at times not without challenges, we see this as an opportunity to learn from our mistakes, and those of others, as we strive to do all we can to restore investor confidence, to improve the structure and practices of financial markets and, above all, to strengthen our own policies and procedures. Our highest priority is to enhance our reputation for integrity in everything we do.

It is a challenging agenda and the implications are far-reaching. Success will, to a large degree, be measured by the extent to which financial institutions like Goldman Sachs can continue to operate effectively. This is important because the role played by integrated investment banks—which bring together the providers and users of capital—is central to well-functioning capital markets and to sustained global growth. Firms like ours are in many ways agents of change. We facilitate entrepreneurship and innovation, help create opportunities for individuals and companies alike, and act as a catalyst for economic reform around the world.

This year our letter is a little longer than usual because we address in more detail some of the most important opportunities and issues we face as a firm.

INVESTMENT BANKING

Investment banking activity continued to suffer from diminished corporate and investor confidence in a tough business environment. Industry volumes for completed mergers decreased again in 2003 and equity underwriting volumes remained low. Global completed mergers decreased 17% from 2002, and were 70% below volumes in 2000, the prior peak. Our results reflected this difficult industry environment. Investment Banking net revenues were $2.71 billion, down 4% from 2002, and pre-tax earnings were $207 million, down from $376 million the year before.

However, despite this difficult environment, we maintained our focus on serving clients and continued as the market leader in our core franchise businesses, including mergers and acquisitions, and IPO, equity, and equity-linked underwriting. In addition, we developed a prominent position in the issuance of high-yield securities. We think the strength of our franchise and the quality of our client relationships are evident in this performance. We do not, however, seek to be number one in all areas. Pursuing market share in some products makes no sense to us when the profitability is too small or non-existent.

We believe that our role as a core advisor to clients has never been stronger. Our investment banking professionals continue to play a vital role in advising senior executives and a broad range of clients throughout the world. Through these relationships, our people are able to identify the needs of our clients and offer solutions by providing advice, products and services from across our firm.

TRADING AND PRINCIPAL INVESTMENTS

Once again in 2003, Trading and Principal Investments produced excellent results. Net revenues were $10.44 billion, a 21% increase from 2002. Pre-tax earnings were $3.51 billion, a 64% increase from 2002.

We measure the effectiveness of our trading businesses by evaluating overall profitability relative to the risk we assume and the opportunities available. While there is no perfect measure of market risk, a topic we'll discuss later in this letter, our risk levels were higher in 2003 than in 2002. We were very pleased with the results our businesses were able to produce by effectively deploying incremental capital.

Fixed Income, Currency and Commodities (FICC) had another record year, with net revenues of $5.60 billion, a 20% increase from 2002. During 2003, FICC operated in a generally favorable environment characterized by tightening corporate credit spreads, low interest rates, a steep yield curve and strong customer demand. As we look forward to 2004, we do not see clear signs that FICC activity levels will slow. However, we know that there is no such thing as a trading backlog and our business opportunities will always depend on the overall environment.

One important aspect of our FICC business that is often overlooked is the range and diversity of activities it comprises. Within the five major areas of FICC—interest rates, credit, mortgages, currencies and commodities—are a wide range of individual operations around the globe. While there can be no guarantee about performance in any of our businesses, we believe that this diversity is an important strength.

Our Equities business continued to face a very challenging environment. Equities net revenues of $4.28 billion increased 7% compared with 2002, primarily due to higher net revenues in principal strategies. While equity markets certainly improved in 2003 relative to the previous few years, conditions remained tough. Commission rates and spreads have continued to decline, the need to commit capital in a variety of circumstances is rising and volume growth is low.

At Goldman Sachs, we have focused on the optimal size and structure for our Equities business in this difficult environment. We are pleased with the results of this effort, which we believe will be an important driver of future performance.

Beginning with the appointment in 2002 of common management for our securities businesses, we have been more closely coordinating the activities of our FICC and Equities businesses to share best practices, capture synergies and drive efficiencies. In 2003, we continued this work, combining our Equities cash and derivatives client businesses under one leadership team. This builds on the experience of a similar combination in FICC in 2000 and will position us well to capture a range of opportunities.

RESEARCH

Research remains a critically important part of the Goldman Sachs franchise. We believe that a strong, differentiated research effort that is firmly aligned with the interests of our investing clients will be an important part of our Equities business for many years to come.

Of course, 2003 began with the brokerage industry's global settlement with various regulators on equities research-related matters. As we have said before, in hindsight we and others could have done a better job. However, we had already begun implementing changes in our research business long before the final settlement, and we have been working diligently to comply in every respect with the new ground rules.

We will continue to shape our research so that the qualities our clients value most—industry expertise, independent thinking and timely insights—are at the forefront of our proposition to investors.

SLK SPECIALIST

Our SLK stock specialist business, as well as the other specialists on the New York Stock Exchange (NYSE), have been, and continue to be, the subject of an intense regulatory review and enforcement action. Much attention has focused on the conduct of specialists within the existing NYSE rules, as well as potential changes to the rules governing the role of specialists.

The role of the specialist and the rules of the NYSE should be evaluated against the proper objective—the development of the best market structure for all participants. In our view, the market structure of the future can take any number of forms, but the goal should be to produce a system that is fair to all investors and one where liquidity is maximized and investors can prioritize price, speed and cost of execution.

We have in the past stated that we are not wedded to any particular market structure. Goldman Sachs is active and successful in markets around the world, many of which make greater use of electronic interfaces than the NYSE. In fact, we have invested in a number of electronic trading platforms. We believe, however, that the specialist performs a valuable role in maintaining an orderly market, particularly during times of market stress or when there are imbalances or dislocations with regard to a single stock. This system has helped to maintain the NYSE as the leading equities exchange in the world. We also believe investors are best served by large liquidity pools and greater use of electronic structures. By centralizing, rather than fragmenting, liquidity, investors will achieve the best possible outcomes.

At this point, we are unable to predict the outcome of the regulatory review or the impact of potential reforms. We can assure you, however, that we will continue to cooperate fully with the regulators and to assist them in every way we can to develop the best equities market possible. Whatever changes are adopted, we feel confident in our ability to compete successfully across our equities franchise, which remains an industry leader.

RISK MANAGEMENT

It is often reported in the media that we have increased our trading risk in recent years to offset the decline in investment banking activity levels. In fact, the same shocks and trends in the economy that have led to the sharp declines in investment banking have also created significant trading opportunities for our clients and for Goldman Sachs.

We believe our willingness to take significant trading risk for appropriate reward is one of the distinguishing features of our firm and gives us a competitive advantage. We benefit in the marketplace because our clients—many of whom are among the world's largest and most sophisticated institutions—value our ability to tailor solutions and our willingness to commit our capital to meet their needs.

Given the significant levels of risk we run in our business, we consider risk management to be one of our most vital functions. Risk management begins at the top of the firm with the establishment of risk limits for major business units and the involvement of our most senior people in critical decisions. In setting limits, there is no magic formula. But we do size our risk in proportion to our capital base and our overall earnings power. Since we went public in 1999, our shareholders' equity has grown more than threefold, to $21.63 billion as of November 2003.

One principal tool we use to measure market risk is Value at Risk (VaR), a statistical measure of the potential loss in value of our trading positions due to adverse market movements over a defined time horizon with a specified confidence level. We use a one-day horizon and a 95% level of confidence. This means that, about once a month, our actual daily trading revenues should be less than our expected daily trading revenues by an amount at least as large as our VaR. In 2003, our average daily VaR was $58 million.

As important as it is to understand what VaR is telling you, it is important to understand what it is not telling you. VaR in no way captures a "worst case" scenario. Shortfalls on a single day can exceed reported VaR by a large amount. In addition, shortfalls can accumulate over a longer period, such as a number of consecutive trading days.

As a predictor of trading results, VaR historically has worked relatively well in stable markets and less well in very volatile and illiquid markets. Recognizing this fact, we also perform various scenario analyses, asking "What if?" about any number of possible events. These scenarios are used to establish limits and to attempt to keep our risk manageable.

No one likes trading losses, but they are a feature of our business. In fact, it is our willingness to tolerate such occasional, sizeable losses that enables us to earn attractive returns over time. And, even when our trading businesses are performing well, results can be uneven.

BALANCE SHEET AND LIQUIDITY

In 2003, our balance sheet grew, reflecting the higher activity levels in our trading and investing businesses and our willingness to deploy our capital to serve clients. While we face risks across every aspect of our business, access to liquidity remains the single most important issue for any financial services firm. There are many events that can create problems for a financial institution — macro events, trading losses, reputational damages, to name a few — but the most serious is a lack of liquidity.

As a result, we place major emphasis on assuring our access to liquidity. The cornerstone of our approach is a "cushion" we maintain in the form of cash and highly liquid securities that averaged some $38 billion in 2003. We think of this cushion as liquidity support in the event of unexpected dislocations in financial markets.

DERIVATIVES

The use of derivatives, a key part of our trading activity, has been the subject of increased debate recently. Derivatives span a wide range — from a simple interest rate swap that allows a company to convert its fixed rate borrowing into a floating rate exposure, to more complex instruments like credit derivatives that allow investors to hedge risk associated with credit exposures in their portfolios.

While derivatives can be misused, they are a vital tool for risk management and risk dispersion. Over the last few years, we have witnessed seven of the ten largest corporate bankruptcies ever with surprisingly little dislocation in global credit markets. The dispersion of risk permitted by derivatives appears to have contributed very significantly to this outcome. Moreover, those financial institutions that have had some of the greatest problems in recent years were hurt in many cases by large unhedged exposures to equity markets.

Of course, the use of derivatives, like other financial instruments, requires a rigorous, hands-on approach to risk management and control. These features were notably absent in some companies whose troubles have been widely publicized. At Goldman Sachs, we maintain an independent control function that monitors all of our trading positions and independently verifies their fair value.

PRINCIPAL INVESTMENTS

After two disappointing years, Principal Investments produced positive results in 2003. Net revenues increased to $566 million, up from negative $35 million in 2002. The increase was attributable to gains and overrides from real estate and corporate investments, including a $293 million unrealized gain on our investment in Sumitomo Mitsui Financial Group (SMFG).

We expect the results from this business to be uneven, as there is a time lag between investing and harvesting. In 2003, we were fortunate to make a number of significant investments and we are optimistic about their return potential. We believe we have improved the quality of the portfolio in the last few years and have made some substantial investments that can drive the performance of this business over the cycle.

We also sold some successful investments during 2003, including part of our holding in Kookmin Bank in South Korea. This deal highlights some of the characteristics of our business that we believe stand us in good stead for the future: our global reach and relationships, our willingness to deploy significant capital swiftly and our ability to take a long view.

Our investment in convertible preferred stock of SMFG carries with it significant volatility. We hold the investment at fair value, which is derived primarily from SMFG's common share price. Since our investment in February 2003, SMFG's share price has closed as low as ¥164,000 and as high as ¥665,000. Significant changes in SMFG's share price produce significant changes in the fair value of our investment, which we report as net revenues each quarter.

Our decision to invest in SMFG was based on our long-term confidence in Japan and the opportunity to strengthen our relationship with one of the most important financial institutions in Japan. Short-term fluctuations in the value of SMFG are not cause for particular concern to us, as long as the fundamentals of SMFG are steady and improving, which we believe to be the case.

ASSET MANAGEMENT AND SECURITIES SERVICES

Our Asset Management and Securities Services business had an excellent year. Net revenues were $2.86 billion, a 14% increase from 2002. Pre-tax earnings were $968 million in 2003, compared with $947 million in 2002.

In Asset Management, net revenues were $1.85 billion, a 12% increase from 2002, primarily reflecting an increase in average assets under management, the contribution from the acquisition of Ayco and increased incentive income. Total assets under management increased 7% to a record $373 billion. Two closely related factors are critical to building our business: the

ability to generate attractive investment performance and the ability to raise new assets.

During 2003, our investment performance, together with our distribution strength, allowed us to generate $15 billion of net client inflows across non-money market asset classes. These increases were offset by $19 billion of outflows in money market assets, as economic prospects improved and higher returns were being generated in other asset classes.

Within our Securities Services business, net revenues were $1.01 billion, up 17% from 2002. This business continues to benefit from the creation and growth of new and existing hedge funds. In addition, the rally in equity markets helped to increase customer balances.

We believe our Asset Management and Securities Services business represents one of our best opportunities for substantial growth.

EXPENSES

Managing expenses in this challenging environment has been one of our highest priorities. During 2003, excluding the impact of acquisitions, we reduced our headcount by 7%. While painful, these reductions were necessary to scale our operations to the available opportunities and were a key factor in our ability to generate an attractive return in 2003.

Our largest expense—in a people business—is compensation, and we track this expense as a percentage of the net revenues we generate in our businesses overall. For 2003, the ratio of compensation to net revenues was 46% versus 48% in 2002.

We remain focused on controlling our non-compensation expenses. However, there are some areas that remain difficult to forecast. For instance, in 2003 we took provisions of $159 million for a number of litigation and regulatory proceedings. Given the range of litigation and investigations underway, these expenses may remain high.

STRATEGY AND COMPETITIVE DYNAMICS

Goldman Sachs is not a financial services conglomerate but an integrated investment bank, securities firm and asset manager. This focused strategy has allowed us to build a strong global franchise—we take pride in being a market leader in Europe and Asia as well as the United States. It has also allowed us to benefit from the long-term growth of the global capital markets which we believe will continue to provide us with excellent growth opportunities over the cycle.

We aspire to be the preeminent global provider of advisory, financing, investment and risk management services to corporations, institutions, governments and high-net-worth individuals. To succeed in this mission, the firm has always placed great reliance on attracting and retaining outstanding people. And we work hard to foster teamwork and encourage creativity, client focus and innovation. We believe that our unique culture, coupled with the quality of our people, is Goldman Sachs' most important competitive strength.

Our business has always been highly competitive and cyclical. We face strong competition today, as in the past, from larger competitors, but we don't view our size as a competitive disadvantage because we have never been constrained by a lack of capital. We believe our biggest challenge is to strengthen our culture of teamwork and excellence in the face of the growing size and scope of our business. We are determined to meet this challenge because we believe our ability to do so is critical to our continued success in executing our global strategy and serving our clients.

STRATEGIC TRANSACTIONS

In 2003, we completed a number of strategic transactions. Our first announcement involved our $1.25 billion investment in SMFG, which we mentioned above. We are pleased with the performance of our investment as well as the other aspects of our relationship with SMFG.

With the credit loss protection provided by SMFG, we initiated our William Street credit extension program. This capability has given us an innovative way to extend credit selectively to our investment-grade clients, while reducing our credit and liquidity risks. By the end of fiscal 2003, $4.32 billion of credit commitments had been made under the program. In addition, our business cooperation agreement with SMFG has already resulted in a number of initiatives. In October, we announced the formation of a joint venture to facilitate the corporate recovery of certain SMFG borrowing clients and to accelerate SMFG's plans to improve its asset quality.

In September, we combined our Australian operations with JBWere to create a new venture called Goldman Sachs JBWere. We own 45% of the new entity, one of the leading investment banking and securities firms in Australia.

We also made several acquisitions in 2003. Our approach to acquisitions is to strengthen our business and build shareholder value, principally through emphasizing bolt-on deals where we can add new clients or acquire new products to provide to our existing clients. 2003 offered us a number of such opportunities.

In July, we acquired The Ayco Company, a leading provider of sophisticated, fee-based financial counsel-

ing in the United States. Ayco enables us to develop further our high-net-worth and asset management businesses by using its extensive portfolio of financial planning capabilities, including tax, estate and charitable planning services.

We also made two acquisitions of power generation assets. In October, we acquired East Coast Power, owner of the 940-megawatt cogeneration facility in Linden, New Jersey, which sells some 80% of its power to the New York City market. In the same month, we announced the acquisition of Cogentrix Energy, an independent power producer based in Charlotte, North Carolina, adding interests in 26 power plants and 3,300 megawatts of generating capacity to our portfolio.

These generation facilities were acquired to complement our existing commodity trading and merchant energy restructuring capabilities. Of course, ownership of physical power assets brings incremental responsibilities of which we are particularly mindful.

BOARD OF DIRECTORS

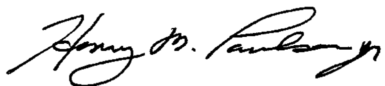
In June, we announced that Claes Dahlbäck, nonexecutive Chairman of Investor AB, and Edward M. Liddy, Chairman of the Board, President and Chief Executive Officer of The Allstate Corporation, were joining our Board of Directors. Claes and Ed are both distinguished business leaders as well as thoughtful corporate directors, and we welcome the contributions they are already making to the Board. The Board has also nominated Lois D. Juliber, Chief Operating Officer of the Colgate-Palmolive Company, to stand for election to our Board of Directors at the March 31 Annual Meeting. In addition, John Thain and John Thornton retired as directors and we thank them for their service on our Board and to our shareholders.

OUTLOOK

On balance, 2003 proved to be a more favorable operating environment than we expected at the beginning of the year. Markets rose, economic growth improved in most major economies and business confidence rose.

Although we expect these trends to continue in 2004, we cannot, of course, predict with certainty what global events, economic or political, in fact will shape the markets in which we work. But, we can—and will—pursue a strategy that permits us to seize business opportunities in an environment of continuing uncertainty and possible volatility. We owe you, our shareholders, nothing less. In terms of our own industry, it is clear that, if anything, regulatory scrutiny has intensified in the U.S. and in other countries around the world. We anticipate that this will continue to be a feature of the environment in which we operate.

That said, we look forward with confidence to 2004 and beyond. Our franchise is stronger than ever. Our people remain focused, dedicated and enthusiastic. We are committed to serving you, our shareholders, by delivering long-term growth and by producing real value for our clients through products and services that strengthen the global capital markets and support economic growth.



HENRY M. PAULSON, JR.
Chairman and Chief Executive Officer

LLOYD C. BLANKFEIN
President and Chief Operating Officer